

SOUTHWEST AIRLINES CO

Form 10-K/A

April 24, 2007

UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549  
Form 10-K/A  
Amendment No. 2

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the transition period from

to  
Commission File No. 1-7259  
Southwest Airlines Co.

(Exact name of registrant as specified in its charter)

Texas  
(State or other jurisdiction of  
incorporation or organization)

74-1563240  
(I.R.S. Employer  
Identification No.)

P.O. Box 36611  
Dallas, Texas  
(Address of principal executive offices)

75235-1611  
(Zip Code)

Registrant's telephone number, including area code:  
(214) 792-4000

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class

Name of Each Exchange on Which Registered

Common Stock (\$1.00 par value)

New York Stock Exchange, Inc.

Securities registered pursuant to Section 12(g) of the Act:

None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark whether the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
Yes  No

The aggregate market value of the Common Stock held by non-affiliates of the registrant was approximately \$12,811,246,960, computed by reference to the closing sale price of the Common Stock on the New York Stock Exchange on June 30, 2006, the last trading day of the registrant's most recently completed second fiscal quarter.

Number of shares of Common Stock outstanding as of the close of business on January 29, 2007: 788,431,522 shares

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for our Annual Meeting of Shareholders to be held May 16, 2007 are incorporated into Part III of this Form 10-K.

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**EXPLANATORY NOTE**

Southwest Airlines Co. is filing this Amendment No. 2 on Form 10-K/A to its Annual Report on Form 10-K for the fiscal year ended December 31, 2006, to include the conformed signature of its independent registered public accounting firm, Ernst & Young LLP, on the Report of Independent Registered Public Accounting Firm included in our Form 10-K on page 55. The signed opinion was obtained by us prior to our filing of the Form 10-K with the Securities and Exchange Commission. No other changes are being made to the Financial Statements. In addition, no changes are being made pursuant to this amendment to any other item of our Form 10-K other than the updating of the Exhibits to include updated Certifications of the Chief Executive and Chief Financial Officers and an updated consent of Ernst & Young, LLP, Independent Registered Public Accounting Firm.

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**Item 8. Financial Statements and Supplementary Data**

**SOUTHWEST AIRLINES CO.**  
**CONSOLIDATED BALANCE SHEET**

|  | December 31,<br>2006                  2005<br>(In millions, except<br>share data) |           |
|--|---|-----------|
| <b>ASSETS</b>                                      |   |           |
| Current assets:                                    |   |           |
| Cash and cash equivalents                          | \$ 1,390  | \$ 2,280  |
| Short-term investments                             | 369   | 251       |
| Accounts and other receivables                     | 241   | 258       |
| Inventories of parts and supplies, at cost         | 181   | 150       |
| Fuel derivative contracts                          | 369   | 641       |
| Prepaid expenses and other current assets          | 51  | 40        |
| <br>   |   |           |
| Total current assets                               | <b>2,601</b>  | 3,620     |
| Property and equipment, at cost:                   |   |           |
| Flight equipment                                   | 11,769  | 10,592    |
| Ground property and equipment                      | 1,356   | 1,256     |
| Deposits on flight equipment purchase contracts    | 734   | 660       |
| <br>   |   |           |
|  | <b>13,859</b>   | 12,508    |
| Less allowance for depreciation and amortization   | <b>3,765</b>  | 3,296     |
| <br>   |   |           |
| Other assets                                       | <b>10,094</b>   | 9,212     |
|  | <b>765</b>  | 1,171     |
|  | <b>\$ 13,460</b>  | \$ 14,003 |
| <br><b>LIABILITIES AND STOCKHOLDERS EQUITY</b>     |   |           |
| Current liabilities:                               |   |           |
| Accounts payable                                   | \$ 643  | \$ 524    |
| Accrued liabilities                                | 1,323   | 2,074     |
| Air traffic liability                              | 799   | 649       |
| Current maturities of long-term debt               | 122   | 601       |
| <br>   |   |           |
| Total current liabilities                          | <b>2,887</b>  | 3,848     |
| Long-term debt less current maturities             | <b>1,567</b>  | 1,394     |
| Deferred income taxes                              | <b>2,104</b>  | 1,681     |
| Deferred gains from sale and leaseback of aircraft | <b>120</b>  | 136       |
| Other deferred liabilities                         | <b>333</b>  | 269       |

Commitments and contingencies

Stockholders' equity:

|   |                  |           |
|---|------------------|-----------|
| Common stock, \$1.00 par value: 2,000,000,000 shares authorized; 807,611,634 and 801,641,645 shares issued in 2006 and 2005, respectively | <b>808</b>       | 802       |
| Capital in excess of par value  | <b>1,142</b>     | 963       |
| Retained earnings   | <b>4,307</b>     | 4,018     |
| Accumulated other comprehensive income  | <b>582</b>       | 892       |
| Treasury stock, at cost: 24,302,215 shares in 2006  | <b>(390)</b>     |           |
| Total stockholders' equity  | <b>6,449</b>     | 6,675     |
|   | <b>\$ 13,460</b> | \$ 14,003 |

See accompanying notes.

**SOUTHWEST AIRLINES CO.**  
**CONSOLIDATED STATEMENT OF INCOME**

|                                      | <b>Years Ended December 31,</b>                |             |             |
|--------------------------------------|--|-------------|-------------|
|                                      | <b>2006</b>                                    | <b>2005</b> | <b>2004</b> |
|                                      | <b>(In millions, except per share amounts)</b> |             |             |
| <b>OPERATING REVENUES:</b>           |  |             |             |
| Passenger                            | \$ 8,750                                       | \$ 7,279    | \$ 6,280    |
| Freight                              | 134  | 133         | 117         |
| Other                                | 202  | 172         | 133         |
| Total operating revenues             | <b>9,086</b>                                   | 7,584       | 6,530       |
| <b>OPERATING EXPENSES:</b>           |  |             |             |
| Salaries, wages, and benefits        | <b>3,052</b>                                   | 2,782       | 2,578       |
| Fuel and oil                         | <b>2,138</b>                                   | 1,341       | 1,000       |
| Maintenance materials and repairs    | <b>468</b>                                     | 446         | 472         |
| Aircraft rentals                     | <b>158</b>                                     | 163         | 179         |
| Landing fees and other rentals       | <b>495</b>                                     | 454         | 408         |
| Depreciation and amortization        | <b>515</b>                                     | 469         | 431         |
| Other operating expenses             | <b>1,326</b>                                   | 1,204       | 1,058       |
| Total operating expenses             | <b>8,152</b>                                   | 6,859       | 6,126       |
| <b>OPERATING INCOME</b>              | <b>934</b>                                     | 725         | 404         |
| <b>OTHER EXPENSES (INCOME):</b>      |  |             |             |
| Interest expense                     | <b>128</b>                                     | 122         | 88          |
| Capitalized interest                 | <b>(51)</b>                                    | (39)        | (39)        |
| Interest income                      | <b>(84)</b>                                    | (47)        | (21)        |
| Other (gains) losses, net            | <b>151</b>                                     | (90)        | 37          |
| Total other expenses (income)        | <b>144</b>                                     | (54)        | 65          |
| <b>INCOME BEFORE INCOME TAXES</b>    | <b>790</b>                                     | 779         | 339         |
| <b>PROVISION FOR INCOME TAXES</b>    | <b>291</b>                                     | 295         | 124         |
| <b>NET INCOME</b>                    | <b>\$ 499</b>                                  | \$ 484      | \$ 215      |
| <b>NET INCOME PER SHARE, BASIC</b>   | <b>\$ .63</b>                                  | \$ .61      | \$ .27      |
| <b>NET INCOME PER SHARE, DILUTED</b> | <b>\$ .61</b>                                  | \$ .60      | \$ .27      |

See accompanying notes.





## SOUTHWEST AIRLINES CO.

## CONSOLIDATED STATEMENT OF STOCKHOLDERS EQUITY

|  | Years Ended December 31, 2006, 2005, and 2004 |  |                      |  |                   | Total        |
|--|---|--|----------------------|--|-------------------|--------------|
|  | Accumulated                                   |  |                      |  |                   |              |
|  | Common<br>Stock                               | Capital<br>in<br>Excess of<br>Par<br>Value | Retained<br>Earnings | Other<br>Comprehensive<br>Income<br>(Loss) | Treasury<br>Stock |              |
|  | (In millions, except per share amounts)       |  |                      |  |                   |              |
| Balance at December 31, 2003   | \$ 789  | \$ 612                                     | \$ 3,506             | \$ 122                                     | \$                | \$ 5,029     |
| Purchase of shares of treasury stock                                   |   |  |                      |  | (246)             | (246)        |
| Issuance of common and treasury stock pursuant to Employee stock plans | 1   | 7  | (93)                 |  | 175               | 90           |
| Tax benefit of options exercised                                       |   | 23   |                      |  |                   | 23           |
| Share-based compensation   |   | 135  |                      |  |                   | 135          |
| Cash dividends, \$.018 per share                                       |   |  | (14)                 |  |                   | (14)         |
| Comprehensive income (loss)  |   |  |                      |  |                   |              |
| Net income   |   |  | 215                  |  |                   | 215          |
| Unrealized gain on derivative instruments                              |   |  |                      | 293  |                   | 293          |
| Other  |   |  |                      | 2  |                   | 2            |
| Total comprehensive income   |   |  |                      |  |                   | 510          |
| Balance at December 31, 2004   | \$ 790  | \$ 777                                     | \$ 3,614             | \$ 417                                     | \$ (71)           | \$ 5,527     |
| Purchase of shares of treasury stock                                   |   |  |                      |  | (55)              | (55)         |
| Issuance of common and treasury stock pursuant to Employee stock plans | 12  | 59   | (66)                 |  | 126               | 131          |
| Tax benefit of options exercised                                       |   | 47   |                      |  |                   | 47           |
| Share-based compensation   |   | 80   |                      |  |                   | 80           |
| Cash dividends, \$.018 per share                                       |   |  | (14)                 |  |                   | (14)         |
| Comprehensive income (loss)  |   |  |                      |  |                   |              |
| Net income   |   |  | 484                  |  |                   | 484          |
| Unrealized gain on derivative instruments                              |   |  |                      | 474  |                   | 474          |
| Other  |   |  |                      | 1  |                   | 1            |
| Total comprehensive income   |   |  |                      |  |                   | 959          |
| Balance at December 31, 2005   | \$ 802  | \$ 963                                     | \$ 4,018             | \$ 892                                     | \$                | \$ 6,675     |
| <b>Purchase of shares of treasury stock</b>                            |   |  |                      |  | <b>(800)</b>      | <b>(800)</b> |
|  | <b>6</b>                                      | <b>39</b>                                  | <b>(196)</b>         |  | <b>410</b>        | <b>259</b>   |

|   |               |                 |                 |               |                 |                 |              |
|---|---------------|-----------------|-----------------|---------------|-----------------|-----------------|--------------|
| <b>Issuance of common and treasury stock pursuant to Employee stock plans</b> |               |                 |                 |               |                 |                 |              |
| <b>Tax benefit of options exercised</b>                                       |               | <b>60</b>       |                 |               |                 |                 | <b>60</b>    |
| <b>Share-based compensation</b>   |               | <b>80</b>       |                 |               |                 |                 | <b>80</b>    |
| <b>Cash dividends, \$.018 per share</b>                                       |               |                 |                 | <b>(14)</b>   |                 |                 | <b>(14)</b>  |
| <b>Comprehensive income (loss)</b>  |               |                 |                 |               |                 |                 |              |
| <b>Net income</b>   |               |                 |                 | <b>499</b>    |                 |                 | <b>499</b>   |
| <b>Unrealized loss on derivative instruments</b>                              |               |                 |                 |               |                 | <b>(306)</b>    | <b>(306)</b> |
| <b>Other</b>  |               |                 |                 |               |                 | <b>(4)</b>      | <b>(4)</b>   |
| <b>Total comprehensive income</b>   |               |                 |                 |               |                 |                 | <b>189</b>   |
| <b>Balance at December 31, 2006</b>   | <b>\$ 808</b> | <b>\$ 1,142</b> | <b>\$ 4,307</b> | <b>\$ 582</b> | <b>\$ (390)</b> | <b>\$ 6,449</b> |              |

See accompanying notes.

## SOUTHWEST AIRLINES CO.

## CONSOLIDATED STATEMENT OF CASH FLOWS

|   | Years Ended December 31, |              |              |
|---|--------------------------|--------------|--------------|
|   | 2006                     | 2005         | 2004         |
|   | (In millions)            |              |              |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                          |              |              |
| Net income  | \$ 499                   | \$ 484       | \$ 215       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                          |              |              |
| Depreciation and amortization   | 515                      | 469          | 431          |
| Deferred income taxes   | 277                      | 291          | 166          |
| Amortization of deferred gains on sale and leaseback of aircraft                  | (16)                     | (16)         | (16)         |
| Share-based compensation expense  | 80                       | 80           | 135          |
| Excess tax benefits from share-based compensation expense                         | (60)                     | (47)         | (23)         |
| Changes in certain assets and liabilities:  |                          |              |              |
| Accounts and other receivables  | (5)                      | (9)          | (75)         |
| Other current assets  | 87                       | (59)         | (44)         |
| Accounts payable and accrued liabilities  | (223)                    | 855          | 231          |
| Air traffic liability   | 150                      | 120          | 68           |
| Other, net  | 102                      | (50)         | (22)         |
| Net cash provided by operating activities   | 1,406                    | 2,118        | 1,066        |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                          |              |              |
| Purchases of property and equipment, net  | (1,399)                  | (1,146)      | (1,707)      |
| Purchases of short-term investments   | (4,509)                  | (1,804)      | (4,487)      |
| Proceeds from sales of short-term investments                                     | 4,392                    | 1,810        | 4,611        |
| Payment for assets of ATA Airlines, Inc.  |                          | (6)          | (34)         |
| Debtor in possession loan to ATA Airlines, Inc.                                   | 20                       |              | (40)         |
| Other, net  | 1                        |              | (1)          |
| Net cash used in investing activities   | (1,495)                  | (1,146)      | (1,658)      |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                          |              |              |
| Issuance of long-term debt  | 300                      | 300          | 520          |
| Proceeds from Employee stock plans  | 260                      | 132          | 88           |
| Payments of long-term debt and capital lease obligations                          | (607)                    | (149)        | (207)        |
| Payments of cash dividends  | (14)                     | (14)         | (14)         |
| Repurchase of common stock  | (800)                    | (55)         | (246)        |
| Excess tax benefits from share-based compensation arrangements                    | 60                       | 47           | 23           |
| Other, net  |                          | (1)          | (8)          |
| Net cash provided by (used in) financing activities                               | (801)                    | 260          | 156          |
| <b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>                       | <b>(890)</b>             | <b>1,232</b> | <b>(436)</b> |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>2,280</b>             | <b>1,048</b> | <b>1,484</b> |

|   |                 |          |          |
|---|-----------------|----------|----------|
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b> | <b>\$ 1,390</b> | \$ 2,280 | \$ 1,048 |
|---|-----------------|----------|----------|

**SUPPLEMENTAL DISCLOSURES**

Cash payments for:

|                                     |       |       |       |
|-------------------------------------|-------|-------|-------|
| Interest, net of amount capitalized | \$ 78 | \$ 71 | \$ 38 |
|-------------------------------------|-------|-------|-------|

|              |       |      |      |
|--------------|-------|------|------|
| Income taxes | \$ 15 | \$ 8 | \$ 2 |
|--------------|-------|------|------|

|   |    |       |    |
|---|----|-------|----|
| Noncash rights to airport gates acquired through reduction in debtor in possession loan to ATA Airlines, Inc. | \$ | \$ 20 | \$ |
|---|----|-------|----|

See accompanying notes.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2006

### 1. Summary of Significant Accounting Policies

#### *Basis of Presentation*

Southwest Airlines Co. (Southwest) is a major domestic airline that provides point-to-point, low-fare service. The Consolidated Financial Statements include the accounts of Southwest and its wholly owned subsidiaries (the Company). All significant intercompany balances and transactions have been eliminated. The preparation of financial statements in conformity with accounting principles generally accepted in the United States (GAAP) requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from these estimates.

#### *Cash and Cash Equivalents*

Cash in excess of that necessary for operating requirements is invested in short-term, highly liquid, income-producing investments. Investments with maturities of three months or less are classified as cash and cash equivalents, which primarily consist of certificates of deposit, money market funds, and investment grade commercial paper issued by major corporations and financial institutions. Cash and cash equivalents are stated at cost, which approximates market value.

#### *Short-Term Investments*

Short-term investments consist of auction rate securities with auction reset periods of less than 12 months. These investments are classified as available-for-sale securities and are stated at fair value. At each reset period, the Company accounts for the transaction as Proceeds from sales of short-term investments for the security relinquished, and a purchase of short-term investment for the security purchased, in the accompanying Consolidated Statement of Cash Flows. Prior year amounts have been adjusted to conform to the current year presentation. Unrealized gains and losses, net of tax, are recognized in Accumulated other comprehensive income (loss) in the accompanying Consolidated Balance Sheet. Realized gains and losses on specific investments, which totaled \$17 million in 2006, \$4 million in 2005, and \$5 million in 2004, are reflected in Interest income in the accompanying Consolidated Income Statement.

#### *Inventories*

Inventories primarily consist of flight equipment expendable parts, materials, aircraft fuel, and supplies. All of these items are carried at average cost. These items are generally charged to expense when issued for use.

#### *Property and Equipment*

Depreciation is provided by the straight-line method to estimated residual values over periods generally ranging from 23 to 25 years for flight equipment and 5 to 30 years for ground property and equipment once the asset is placed in service. Residual values estimated for aircraft are 15 percent and for ground property and equipment range from zero to 10 percent. Property under capital leases and related obligations are recorded at an amount equal to the present value of future minimum lease payments computed on the basis of the Company's incremental borrowing rate or, when known, the interest rate implicit in the lease. Amortization of property under capital leases is on a straight-line basis

over the lease term and is included in depreciation expense.

In estimating the lives and expected residual values of its aircraft, the Company primarily has relied upon actual experience with the same or similar aircraft types and recommendations from Boeing, the manufacturer of the Company's aircraft. Subsequent revisions to these estimates, which can be significant, could be caused by changes to the Company's maintenance program, modifications or improvements to the aircraft, changes in utilization of the aircraft (actual flight hours or cycles during a given period of time), governmental regulations on aging aircraft, changing market prices of new and used aircraft of the same or similar types, etc. The Company evaluates its estimates and assumptions each reporting period and, when warranted, adjusts these estimates and assumptions. Generally, these adjustments are accounted for on a prospective basis through depreciation and amortization expense, as required by GAAP.

When appropriate, the Company evaluates its long-lived assets used in operations for impairment. Impairment losses would be recorded when events and circumstances indicate that an asset might be impaired and the undiscounted cash flows to be generated by that asset are less than the carrying amounts of the asset. Factors that would indicate potential impairment include, but are not limited to, significant decreases in the market value of the long-lived asset(s), a significant change in the long-lived asset's physical condition, operating or cash flow losses

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

associated with the use of the long-lived asset, etc. Southwest has continued to operate all of its aircraft and continues to experience positive cash flow.

### *Aircraft and Engine Maintenance*

The cost of scheduled inspections and repairs and routine maintenance costs for all aircraft and engines are charged to maintenance expense as incurred. Modifications that significantly enhance the operating performance or extend the useful lives of aircraft or engines are capitalized and amortized over the remaining life of the asset.

### *Intangible Assets*

Intangible assets primarily consist of leasehold rights to airport owned gates. These assets are amortized on a straight-line basis over the expected useful life of the lease, approximately 20 years. The accumulated amortization related to the Company's intangible assets at December 31, 2006, and 2005, was \$5 million and \$2 million, respectively. The Company periodically assesses its intangible assets for impairment in accordance with SFAS 142, *Goodwill and Other Intangible Assets*; however, no impairments have been noted.

### *Revenue Recognition*

Tickets sold are initially deferred as Air traffic liability. Passenger revenue is recognized when transportation is provided. Air traffic liability primarily represents tickets sold for future travel dates and estimated refunds and exchanges of tickets sold for past travel dates. The majority of the Company's tickets sold are nonrefundable. Tickets that are sold but not flown on the travel date (whether refundable or nonrefundable) can be reused for another flight, up to a year from the date of sale, or refunded (if the ticket is refundable). A small percentage of tickets (or partial tickets) expire unused. The Company estimates the amount of future refunds and exchanges, net of forfeitures, for all unused tickets once the flight date has passed. These estimates are based on historical experience over many years. The Company and members of the airline industry have consistently applied this accounting method to estimate revenue from forfeited tickets at the date travel is provided. Estimated future refunds and exchanges included in the air traffic liability account are constantly evaluated based on subsequent refund and exchange activity to validate the accuracy of the Company's revenue recognition method with respect to forfeited tickets.

Events and circumstances outside of historical fare sale activity or historical Customer travel patterns can result in actual refunds, exchanges or forfeited tickets differing significantly from estimates; however, these differences have historically not been material. Additional factors that may affect estimated refunds, exchanges, and forfeitures include, but may not be limited to, the Company's refund and exchange policy, the mix of refundable and nonrefundable fares, and fare sale activity. The Company's estimation techniques have been consistently applied from year to year; however, as with any estimates, actual refund and exchange activity may vary from estimated amounts.

### *Frequent Flyer Program*

The Company accrues the estimated incremental cost of providing free travel for awards earned under its Rapid Rewards frequent flyer program. The estimated incremental cost includes direct passenger costs such as fuel, food, and other operational costs, but does not include any contribution to overhead or profit. The Company also sells frequent flyer credits and related services to companies participating in its Rapid Rewards frequent flyer program. Funds received from the sale of flight segment credits are accounted for under the residual value method. The portion of those funds associated with future travel are deferred and recognized as Passenger revenue when the ultimate free

travel awards are flown or the credits expire unused. The portion of the funds not associated with future travel are recognized in Other revenue in the period earned.

***Advertising***

The Company expenses the costs of advertising as incurred. Advertising expense for the years ended December 31, 2006, 2005, and 2004 was \$182 million, \$173 million, and \$158 million, respectively.

***Share-Based Employee Compensation***

The Company has stock-based compensation plans covering the majority of its Employee groups, including a plan covering the Company's Board of Directors and plans related to employment contracts with one Executive Officer of the Company. The Company accounts for stock-based compensation utilizing the fair value recognition provisions of SFAS No. 123R, Share-Based Payment. See Note 13.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

### *Financial Derivative Instruments*

The Company accounts for financial derivative instruments utilizing Statement of Financial Accounting Standards No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities*, as amended. The Company utilizes various derivative instruments, including crude oil, unleaded gasoline, and heating oil-based derivatives, to attempt to reduce the risk of its exposure to jet fuel price increases. These instruments primarily consist of purchased call options, collar structures, and fixed-price swap agreements, and upon proper qualification are accounted for as cash-flow hedges, as defined by SFAS 133. The Company has also entered into interest rate swap agreements to convert a portion of its fixed-rate debt to floating rates. These interest rate hedges are accounted for as fair value hedges, as defined by SFAS 133.

Since the majority of the Company's financial derivative instruments are not traded on a market exchange, the Company estimates their fair values. Depending on the type of instrument, the values are determined by the use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets. Also, since there is not a reliable forward market for jet fuel, the Company must estimate the future prices of jet fuel in order to measure the effectiveness of the hedging instruments in offsetting changes to those prices, as required by SFAS 133. Forward jet fuel prices are estimated through utilization of a statistical-based regression equation with data from market forward prices of like commodities. This equation is then adjusted for certain items, such as transportation costs, that are stated in the Company's fuel purchasing contracts with its vendors. See Note 10 for further information on SFAS 133 and financial derivative instruments.

### *Income Taxes*

The Company accounts for deferred income taxes utilizing Statement of Financial Accounting Standards No. 109 (SFAS 109), *Accounting for Income Taxes*, as amended. SFAS 109 requires an asset and liability method, whereby deferred tax assets and liabilities are recognized based on the tax effects of temporary differences between the financial statements and the tax bases of assets and liabilities, as measured by current enacted tax rates. When appropriate, in accordance with SFAS 109, the Company evaluates the need for a valuation allowance to reduce deferred tax assets.

## **2. Accounting Changes and Recent Accounting Developments**

### *Aircraft and Engine Maintenance*

Effective January 1, 2006, the Company changed its method of accounting for scheduled airframe inspection and repairs for 737-300 and 737-500 aircraft from the deferral method to the direct expense method. The Company recorded the change in accounting in accordance with Statement of Financial Accounting Standards No. 154, *Accounting Changes and Error Corrections* (SFAS 154), which was effective for calendar year companies on January 1, 2006. SFAS 154 requires that all elective accounting changes be made on a retrospective basis. As such, the accompanying financial statements and footnotes were adjusted in first quarter 2006 to apply the direct expense method retrospectively to all prior periods.

For the years ended December 31, 2004 and 2005, Maintenance materials and repairs expense was increased by \$15 million in each year, resulting in a reduction in net income of \$9 million for each year. Net income per share, basic and diluted, was each reduced by \$.01 per share for both 2004 and 2005. The impact of adopting the direct expense method on net income for 2006 was not material.

***Share-Based Compensation***

Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R,

Share-Based Payment using the modified retrospective transition method. Among other items, SFAS 123R eliminates the use of Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees and related Interpretations, and the intrinsic value method of accounting, and requires companies to recognize the cost of Employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements. Under the modified retrospective transition method, all prior periods have been retrospectively adjusted to conform to the requirements of SFAS 123R.

As part of the adoption of SFAS 123R, the Company recorded cumulative share-based compensation expense, net of taxes, of \$409 million for the period 1995-2005, resulting in a reduction to Retained earnings in the Consolidated Balance Sheet as of December 31, 2005. This adjustment, along with the creation of a net Deferred income tax asset in the amount of \$130 million, resulted in an offsetting increase to Capital in excess of

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

par value in the amount of \$539 million in the Consolidated Balance Sheet as of December 31, 2005. The Deferred tax asset represents the portion of the cumulative expense related to stock options expected to result in a future tax deduction. For further information, see Note 13.

The following tables summarize the changes within Stockholders' Equity as of December 31, 2003, 2004, and 2005 from the change in the Company's method of accounting for airframe maintenance and the adoption of SFAS 123R (in millions):

| <b>As of December 31, 2003</b>                | <b>As Originally Reported</b> | <b>Effect of Maintenance Change</b> | <b>Effect of SFAS 123R Change</b> | <b>As Adjusted</b> |
|---|-------------------------------|-------------------------------------|-----------------------------------|--------------------|
| Common stock                                  | \$ 789                        | \$                                  | \$                                | \$ 789             |
| Capital in excess of par value                | 258                           |                                     | 354                               | 612                |
| Retained earnings                             | 3,883                         | (112)                               | (265)                             | 3,506              |
| Accumulated other comprehensive income (loss) | 122                           |                                     |                                   | 122                |
| Treasury stock                                |                               |                                     |                                   |                    |
| Total stockholders' equity                    | \$ 5,052                      | \$ (112)                            | \$ 89                             | \$ 5,029           |

| <b>As of December 31, 2004</b>                | <b>As Originally Reported</b> | <b>Effect of Maintenance Change</b> | <b>Effect of SFAS 123R Change</b> | <b>As Adjusted</b> |
|---|-------------------------------|-------------------------------------|-----------------------------------|--------------------|
| Common stock                                  | \$ 790                        | \$                                  | \$                                | \$ 790             |
| Capital in excess of par value                | 299                           |                                     | 478                               | 777                |
| Retained earnings                             | 4,089                         | (121)                               | (354)                             | 3,614              |
| Accumulated other comprehensive income (loss) | 417                           |                                     |                                   | 417                |
| Treasury stock                                | (71)                          |                                     |                                   | (71)               |
| Total stockholders' equity                    | \$ 5,524                      | \$ (121)                            | \$ 124                            | \$ 5,527           |

| <b>As of December 31, 2005</b> | <b>As Originally Reported</b> | <b>Effect of Maintenance Change</b> | <b>Effect of SFAS 123R Change</b> | <b>As Adjusted</b> |
|--------------------------------|-------------------------------|-------------------------------------|-----------------------------------|--------------------|
|--------------------------------|-------------------------------|-------------------------------------|-----------------------------------|--------------------|

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|   |    |       |          |        |       |       |
|---|----|-------|----------|--------|-------|-------|
| Common stock                                  | \$ | 802   | \$       | \$     | \$    | 802   |
| Capital in excess of par value                |    | 424   |          |        | 539   | 963   |
| Retained earnings                             |    | 4,557 | (130)    |        | (409) | 4,018 |
| Accumulated other comprehensive income (loss) |    | 892   |          |        |       | 892   |
| Treasury stock                                |    |       |          |        |       |       |
| Total stockholders' equity                    | \$ | 6,675 | \$ (130) | \$ 130 | \$    | 6,675 |

***Postretirement Benefits***

In September 2006, the FASB issued statement No. 158, Employers Accounting for Defined Benefit Pensions and Other Postretirement Plans (an amendment of FASB Statements No. 87, 88, 106, and 123R, (SFAS 158). On December 31, 2006, the Company adopted the recognition and disclosure provisions of Statement 158. Statement 158 requires plan sponsors of defined benefit pension and other postretirement benefit plans (collectively, postretirement benefit plans ) to recognize the funded status of their postretirement benefit plans in the statement of financial position, measure the fair value of plan assets and benefit obligations as of the date of the fiscal year-end statement of financial position, and provide additional disclosures. The effect of adopting Statement 158 on the Company's financial

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

condition at December 31, 2006 has been included in the accompanying consolidated financial statements. Statement 158 did not have an effect on the Company's consolidated financial condition at December 31, 2005 or 2004. See Note 14 for further discussion.

***Recent Accounting Developments***

In July 2006, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*—an interpretation of FASB Statement No. 109 (FIN 48), which clarifies the accounting and disclosure for uncertainty in tax positions, as defined. FIN 48 seeks to reduce the diversity in practice associated with certain aspects of the recognition and measurement related to accounting for income taxes. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company does not expect the interpretation will have a material impact on its results from operations or financial position.

In September 2006, the FASB issued statement No. 157, *Fair Value Measurements*, (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in accordance with accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007, with earlier application encouraged. Any amounts recognized upon adoption as a cumulative effect adjustment will be recorded to the opening balance of retained earnings in the year of adoption. The Company has not yet determined the impact of this Statement on its financial condition and results of operations.

**3. Acquisition of Certain Assets**

In fourth quarter 2004, Southwest was selected as the winning bidder at a bankruptcy-court approved auction for certain ATA Airlines, Inc. (ATA) assets. As part of the transaction, which was approved in December 2004, Southwest agreed to pay \$40 million for certain ATA assets, consisting of the leasehold rights to six of ATA's leased Chicago Midway Airport gates and the rights to a leased aircraft maintenance hangar at Chicago Midway Airport. In addition, Southwest provided ATA with \$40 million in debtor-in-possession financing while ATA remained in bankruptcy, and also guaranteed the repayment of an ATA construction loan to the City of Chicago for \$7 million. As part of this original transaction, Southwest committed, upon ATA's emergence from bankruptcy, to convert the debtor-in-possession financing to a term loan, payable over five years, and to invest \$30 million cash in ATA convertible preferred stock.

During fourth quarter 2005, ATA entered into an agreement in which an investor, MatlinPatterson Global Opportunities Partners II, would provide financing to enable ATA to emerge from bankruptcy. As part of this transaction, Southwest entered into an agreement with ATA to acquire the leasehold rights to four additional leased gates at Chicago Midway Airport in exchange for a \$20 million reduction in the Company's debtor-in-possession loan. Upon ATA's emergence from bankruptcy, which took place on February 28, 2006, ATA repaid the remaining \$20 million balance of the debtor-in-possession financing to the Company, and provided a letter of credit to support Southwest's obligation under the construction loan to the City of Chicago. In addition, Southwest was relieved of its commitment to purchase ATA convertible preferred stock.

Southwest and ATA agreed on a code share arrangement, which was approved by the Department of Transportation in January 2005. Under the agreement, which has since been expanded, each carrier can exchange passengers on certain designated flights. Sales of the code share flights began in January 2005, with travel dates beginning in February 2005. As part of the December 2005 agreement with ATA, Southwest has enhanced its codeshare arrangement with

ATA to include additional flights and destinations, among other items. In addition, the Company and ATA have instituted enhancements to Southwest's Rapid Rewards frequent flyer program to provide new award destinations via ATA.

#### **4. Commitments**

The Company's contractual purchase commitments primarily consist of scheduled aircraft acquisitions from Boeing. As of December 31, 2006, the Company had contractual purchase commitments with Boeing for 37 737-700 aircraft deliveries in 2007, 30 scheduled for delivery in 2008, 18 in 2009, and ten each in 2010-2012. In addition, the Company has options and purchase rights for an additional 168 737-700s that it may acquire during 2008-2014. The Company has the option, which must be exercised 18 months prior to the contractual delivery date, to substitute 737-600s or 737-800s for the 737-700s. As of December 31, 2006, aggregate funding needed for firm commitments is approximately \$3.1 billion, subject to adjustments for inflation, due as follows: \$1.0 billion in 2007, \$758 million in 2008, \$467 million

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

in 2009, \$341 million in 2010, \$315 million in 2011, and \$184 million thereafter.

**5. Accrued Liabilities**

|                            | <b>2006</b>          | <b>2005</b>     |
|----------------------------|----------------------|-----------------|
|                            | <b>(In millions)</b> |                 |
| Retirement plans (Note 14) | \$ 165               | \$ 142          |
| Aircraft rentals           | 128                  | 116             |
| Vacation pay               | 151                  | 135             |
| Advances and deposits      | 546                  | 955             |
| Deferred income taxes      | 78                   | 489             |
| Other                      | 255                  | 237             |
| Accrued liabilities        | <b>\$ 1,323</b>      | <b>\$ 2,074</b> |

**6. Revolving Credit Facility**

The Company has a revolving credit facility under which it can borrow up to \$600 million from a group of banks. The facility expires in August 2010 and is unsecured. At the Company's option, interest on the facility can be calculated on one of several different bases. For most borrowings, Southwest would anticipate choosing a floating rate based upon LIBOR. If the facility had been fully drawn at December 31, 2006, the spread over LIBOR would be 62.5 basis points given Southwest's credit rating at that date. The facility also contains a financial covenant requiring a minimum coverage ratio of adjusted pretax income to fixed obligations, as defined. As of December 31, 2006, the Company is in compliance with this covenant, and there are no outstanding amounts borrowed under this facility.

**7. Long-Term Debt**

|                                   | <b>2006</b>          | <b>2005</b> |
|-----------------------------------|----------------------|-------------|
|                                   | <b>(In millions)</b> |             |
| Zero coupon Notes due 2006        | \$                   | \$ 58       |
| Pass Through Certificates         |                      | 523         |
| 77/8% Notes due 2007              | 100                  | 100         |
| French Credit Agreements due 2012 | 37                   | 41          |
| 61/2% Notes due 2012              | 369                  | 370         |
| 51/4% Notes due 2014              | 336                  | 340         |
| 53/4% Notes due 2016              | 300                  |             |
| 51/8% Notes due 2017              | 300                  | 300         |
| French Credit Agreements due 2017 | 100                  | 106         |
| 73/8% Debentures due 2027         | 100                  | 100         |
| Capital leases (Note 8)           | 63                   | 74          |

|                                    |                 |          |
|------------------------------------|-----------------|----------|
|                                    | <b>1,705</b>    | 2,012    |
| Less current maturities            | <b>122</b>      | 601      |
| Less debt discount and issue costs | <b>16</b>       | 17       |
|                                    | <b>\$ 1,567</b> | \$ 1,394 |

During December 2006, the Company issued \$300 million senior unsecured Notes due 2016. The notes bear interest at 5.75 percent, payable semi-annually in arrears, with the first payment due on June 15, 2007. Southwest used the net proceeds from the issuance of the



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

notes, approximately \$297 million, for general corporate purposes.

During 2006, the Company redeemed the balance of its \$529 million face value Pass Through Certificates; \$65 million for the Class A-1 certificates was redeemed in May 2006 and \$464 million for the Class A-2 and Class B certificates was redeemed in November 2006. The Company's interest rate swap agreement associated with the Class A-2 certificates, which was reflected as a reduction in the value of that debt in the amount of \$6 million at December 31, 2005, expired concurrent with the redemption of those certificates in November 2006.

During 2006, the Company redeemed two separate \$29 million non-interest bearing notes on their maturity dates of February 24, 2006 and April 28, 2006, respectively.

During February 2005, the Company issued \$300 million senior unsecured Notes due 2017. The notes bear interest at 5.125 percent, payable semi-annually in arrears, with the first payment made on September 1, 2005. Southwest used the net proceeds from the issuance of the notes, approximately \$296 million, for general corporate purposes.

In fourth quarter 2004, the Company entered into four identical 13-year floating-rate financing arrangements, whereby it borrowed a total of \$112 million from French banking partnerships. Although the interest on the borrowings are at floating rates, the Company estimates that, considering the full effect of the net present value benefits included in the transactions, the effective economic yield over the 13-year term of the loans will be approximately LIBOR minus 45 basis points. Principal and interest are payable semi-annually on June 30 and December 31 for each of the loans, and the Company may terminate the arrangements in any year on either of those dates, with certain conditions. The Company pledged four aircraft as collateral for the transactions.

In September 2004, the Company issued \$350 million senior unsecured Notes due 2014. The notes bear interest at 5.25 percent, payable semi-annually in arrears, on April 1 and October 1. Concurrently, the Company entered into an interest-rate swap agreement to convert this fixed-rate debt to a floating rate. See Note 10 for more information on the interest-rate swap agreement. Southwest used the net proceeds from the issuance of the notes, approximately \$346 million, for general corporate purposes.

On March 1, 2002, the Company issued \$385 million senior unsecured Notes due March 1, 2012. The notes bear interest at 6.5 percent, payable semi-annually on March 1 and September 1. Southwest used the net proceeds from the issuance of the notes, approximately \$380 million, for general corporate purposes. During 2003, the Company entered into an interest rate swap agreement relating to these notes. See Note 10 for further information.

In fourth quarter 1999, the Company entered into two identical 13-year floating rate financing arrangements, whereby it borrowed a total of \$56 million from French banking partnerships. Although the interest on the borrowings are at floating rates, the Company estimates that, considering the full effect of the net present value benefits included in the transactions, the effective economic yield over the 13-year term of the loans will be approximately LIBOR minus 67 basis points. Principal and interest are payable semi-annually on June 30 and December 31 for each of the loans and the Company may terminate the arrangements in any year on either of those dates, with certain conditions. The Company pledged two aircraft as collateral for the transactions.

On February 28, 1997, the Company issued \$100 million of senior unsecured 7<sup>3</sup>/<sub>8</sub>% Debentures due March 1, 2027. Interest is payable semi-annually on March 1 and September 1. The debentures may be redeemed, at the option of the Company, in whole at any time or in part from time to time, at a redemption price equal to the greater of the principal amount of the debentures plus accrued interest at the date of redemption or the sum of the present values of the remaining scheduled payments of principal and interest thereon, discounted to the date of redemption at the

comparable treasury rate plus 20 basis points, plus accrued interest at the date of redemption.

During 1992, the Company issued \$100 million of senior unsecured 77/8% Notes due September 1, 2007. Interest is payable semi-annually on March 1 and September 1. The notes are not redeemable prior to maturity.

The net book value of the assets pledged as collateral for the Company's secured borrowings, primarily aircraft and engines, was \$164 million at December 31, 2006.

As of December 31, 2006, aggregate annual principal maturities of debt and capital leases (not including amounts associated with interest rate swap agreements, and interest on capital leases) for the five-year period ending December 31, 2011, were \$123 million in 2007,

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$25 million in 2008, \$27 million in 2009, \$28 million in 2010, \$25 million in 2011, and \$1.5 billion thereafter.

**8. Leases**

The Company had nine aircraft classified as capital leases at December 31, 2006. The amounts applicable to these aircraft included in property and equipment were:

|                               | <b>2006</b>          | <b>2005</b> |
|-------------------------------|----------------------|-------------|
|                               | <b>(In millions)</b> |             |
| Flight equipment              | <b>\$ 168</b>        | \$ 164      |
| Less accumulated depreciation | <b>123</b>           | 113         |
|                               | <b>\$ 45</b>         | \$ 51       |

Total rental expense for operating leases, both aircraft and other, charged to operations in 2006, 2005, and 2004 was \$433 million, \$409 million, and \$403 million, respectively. The majority of the Company's terminal operations space, as well as 84 aircraft, were under operating leases at December 31, 2006. Future minimum lease payments under capital leases and noncancelable operating leases with initial or remaining terms in excess of one year at December 31, 2006, were:

|   | <b>Capital<br/>Leases</b> | <b>Operating Leases<br/>(In millions)</b> |
|---|---------------------------|---|
| 2007                                    | \$ 16                     | \$ 360                                    |
| 2008                                    | 16                        | 318                                       |
| 2009                                    | 16                        | 280                                       |
| 2010                                    | 15                        | 250                                       |
| 2011                                    | 12                        | 203                                       |
| After 2011                              |                           | 1,000                                     |
| Total minimum lease payments            | 75                        | \$ 2,411                                  |
| Less amount representing interest       | 12                        |   |
| Present value of minimum lease payments | 63                        |   |
| Less current portion                    | 12                        |   |
| Long-term portion                       | \$ 51                     |   |

The aircraft leases generally can be renewed at rates based on fair market value at the end of the lease term for one to five years. Most aircraft leases have purchase options at or near the end of the lease term at fair market value, generally limited to a stated percentage of the lessor's defined cost of the aircraft.

#### **9. Consolidation of Reservations Centers**

In November 2003, the Company announced the consolidation of its nine Reservations Centers into six, effective February 28, 2004. This decision was made in response to the established shift by Customers to the internet as a preferred way of booking travel. The Company's website, [www.southwest.com](http://www.southwest.com), now accounts for over 70 percent of ticket bookings and, as a consequence, demand for phone contact has dramatically decreased. During first quarter 2004, the Company closed its Reservations Centers located in Dallas, Texas, Salt Lake City, Utah, and Little Rock, Arkansas. The Company provided the 1,900 affected Employees at these locations the opportunity to relocate to another of the Company's remaining six centers. Those Employees choosing not to relocate, approximately 55 percent of the total affected, were offered support packages, which included severance pay, flight benefits, medical coverage, and job-search assistance, depending on length of service with the Company. The total cost associated with the Reservations Center consolidation, recognized in first quarter 2004, was approximately \$18 million. Employee severance and benefit costs were reflected in Salaries, wages, and benefits, and the majority of other costs in Other

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

operating expenses in the Consolidated Statement of Income. The total remaining amount accrued (not yet paid) was immaterial at December 31, 2006.

**10. Derivative and Financial Instruments**

*Fuel Contracts*

Airline operators are inherently dependent upon energy to operate and, therefore, are impacted by changes in jet fuel prices. Jet fuel and oil consumed during 2006, 2005, and 2004 represented approximately 26.2 percent, 19.6 percent, and 16.3 percent of Southwest's operating expenses, respectively. The reason that fuel and oil has become an increasingly large portion of the Company's operating expenses has been due to the dramatic increase in all energy prices over this period. The Company endeavors to acquire jet fuel at the lowest possible cost. Because jet fuel is not traded on an organized futures exchange, there are limited opportunities to hedge directly in jet fuel. However, the Company has found that financial derivative instruments in other commodities, such as crude oil, and refined products such as heating oil and unleaded gasoline, can be useful in decreasing its exposure to jet fuel price increases. The Company does not purchase or hold any derivative financial instruments for trading purposes.

The Company has utilized financial derivative instruments for both short-term and long-term time frames. In addition to the significant protective fuel derivative positions the Company had in place during 2006, the Company also has significant future positions. The Company currently has a mixture of purchased call options, collar structures, and fixed price swap agreements in place to protect against nearly 95 percent of its 2007 total anticipated jet fuel requirements at average crude oil equivalent prices of approximately \$50 per barrel, and has also added refinery margins on most of those positions. Based on current growth plans, the Company also has fuel derivative contracts in place for 65 percent of its expected fuel consumption for 2008 at approximately \$49 per barrel, over 50 percent for 2009 at approximately \$51 per barrel, over 25 percent for 2010 at \$63 per barrel, approximately 15 percent in 2011 at \$64 per barrel, and 15 percent in 2012 at \$63 per barrel.

Upon proper qualification, the Company endeavors to account for its fuel derivative instruments as cash flow hedges, as defined in Statement of Financial Accounting Standards No. 133, *Accounting for Derivative Instruments and Hedging Activities*, as amended (SFAS 133). Under SFAS 133, all derivatives designated as hedges that meet certain requirements are granted special hedge accounting treatment. Generally, utilizing the special hedge accounting, all periodic changes in fair value of the derivatives designated as hedges that are considered to be effective, as defined, are recorded in Accumulated other comprehensive income until the underlying jet fuel is consumed. See Note 11 for further information on Accumulated other comprehensive income. The Company is exposed to the risk that periodic changes will not be effective, as defined, or that the derivatives will no longer qualify for special hedge accounting. Ineffectiveness, as defined, results when the change in the fair value of the derivative instrument exceeds the change in the value of the Company's expected future cash outlay to purchase and consume jet fuel. To the extent that the periodic changes in the fair value of the derivatives are not effective, that ineffectiveness is recorded to Other gains and losses in the income statement. Likewise, if a hedge ceases to qualify for hedge accounting, any change in the fair value of derivative instruments since the last period is recorded to Other gains and losses in the income statement in the period of the change.

Ineffectiveness is inherent in hedging jet fuel with derivative positions based in other crude oil related commodities, especially given the magnitude of the current fair market value of the Company's fuel derivatives and the recent volatility in the prices of refined products. Due to the volatility in markets for crude oil and related products, the Company is unable to predict the amount of ineffectiveness each period, including the loss of hedge accounting,

which could be determined on a derivative by derivative basis or in the aggregate. This may result, and has resulted, in increased volatility in the Company's results. The significant increase in the amount of hedge ineffectiveness and unrealized gains and losses on derivative contracts settling in future periods recorded during 2005 and 2006 has been due to a number of factors. These factors included: the significant fluctuation in energy prices, the number of derivative positions the Company holds, significant weather events that have affected refinery capacity and the production of refined products, and the volatility of the different types of products the Company uses for protection. The number of instances in which the Company has discontinued hedge accounting for specific hedges and for specific refined products, such as unleaded gasoline, has increased recently, primarily due to these reasons. In these cases, the Company has determined that the hedges will not regain effectiveness in the time period remaining until settlement and therefore must discontinue special hedge

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

accounting, as defined by SFAS 133. When this happens, any changes in fair value of the derivative instruments are marked to market through earnings in the period of change. However, even though these derivatives may not qualify for SFAS 133 special hedge accounting, the Company continues to hold the instruments as it believes they continue to represent good economic hedges in its goal to minimize jet fuel costs. As the fair value of the Company's hedge positions increases in amount, there is a higher degree of probability that there will be continued variability recorded in the income statement and that the amount of hedge ineffectiveness and unrealized gains or losses for changes in value of the derivatives recorded in future periods will be material. This is primarily due to the fact that small differences in the correlation of crude oil related products are leveraged over large dollar volumes.

Primarily due to the significant decrease in fair values of the Company's fuel derivatives and the loss of hedge accounting for specific hedges, during 2006, the Company recognized approximately \$101 million of net losses in Other (gains) losses, net, related to the ineffectiveness of its hedges and the loss of hedge accounting for certain fuel derivatives. Of this net total, approximately \$42 million was unrealized, mark-to-market losses for changes in fair value of derivatives as a result of the discontinuation of hedge accounting for certain contracts that will settle in future periods; \$20 million was ineffectiveness and mark-to-market losses related to contracts that settled during 2006; and \$39 million was losses related to unrealized ineffectiveness for changes in value of hedges designated for future periods. During 2005, the Company recognized approximately \$110 million of additional gains in Other (gains) losses, net, related to the ineffectiveness of its hedges and the loss of hedge accounting for certain fuel derivatives. Of this amount, approximately \$77 million was gains from unrealized, mark-to-market changes in the fair value of derivatives due to the discontinuation of hedge accounting for certain contracts that will settle in future periods, approximately \$9 million was gains from ineffectiveness associated with hedges designated for future periods, and \$24 million was ineffectiveness and mark-to-market gains related to hedges that settled during 2005. During 2004, the Company recognized approximately \$13 million of additional expense in Other (gains) losses, net, related to the ineffectiveness of its hedges. During 2006, 2005, and 2004, the Company recognized approximately \$52 million, \$35 million, and \$24 million of net expense, respectively, related to amounts excluded from the Company's measurements of hedge effectiveness, in Other (gains) losses, net.

During 2006, 2005, and 2004, the Company recognized pretax gains in Fuel and oil expense of \$634 million, \$892 million, and \$455 million, respectively, from hedging activities. At December 31, 2006 and 2005, approximately \$42 million and \$83 million due from third parties from settled derivative contracts is included in Accounts and other receivables in the accompanying Consolidated Balance Sheet. The fair value of the Company's financial derivative instruments at December 31, 2006, was a net asset of approximately \$999 million. The current portion of these financial derivative instruments, \$369 million, is classified as Fuel derivative contracts and the long-term portion, \$630 million, is classified as Other assets in the Consolidated Balance Sheet. The fair value of the derivative instruments, depending on the type of instrument, was determined by the use of present value methods or standard option value models with assumptions about commodity prices based on those observed in underlying markets.

As of December 31, 2006, the Company had approximately \$584 million in unrealized gains, net of tax, in Accumulated other comprehensive income related to fuel hedges. Included in this total are approximately \$243 million in net unrealized gains that are expected to be realized in earnings during 2007.

***Interest Rate Swaps***

The Company is party to an interest rate swap agreement relating to its \$385 million 6.5% senior unsecured notes due 2012, in which the floating rate is set in arrears. Under the agreement, the Company pays the London InterBank Offered Rate (LIBOR) plus a margin every six months and receives 6.5% every six months on a notional amount of

\$385 million until 2012. The average floating rate paid under this agreement during 2006 is estimated to be 7.63 percent based on actual and forward rates at December 31, 2006.

The Company is also a party to an interest rate swap agreement relating to its \$350 million 5.25% senior unsecured notes due 2014, in which the floating rate is set in advance. Under this agreement, the Company pays LIBOR plus a margin every six months and receives 5.25% every six months on a notional amount of \$350 million until 2014. The average floating rate paid under this agreement during 2006 was 5.69 percent.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The primary objective for the Company's use of interest rate hedges is to reduce the volatility of net interest income by better matching the repricing of its assets and liabilities. The Company's interest rate swap agreements qualify as fair value hedges, as defined by SFAS 133. The fair value of the interest rate swap agreements, which are adjusted regularly, are recorded in the Consolidated Balance Sheet, as necessary, with a corresponding adjustment to the carrying value of the long-term debt. The fair value of the interest rate swap agreements, excluding accrued interest, at December 31, 2006, was a liability of approximately \$30 million and is recorded in Other deferred liabilities in the Consolidated Balance Sheet. In accordance with fair value hedging, the offsetting entry is an adjustment to decrease the carrying value of long-term debt. See Note 7.

Outstanding financial derivative instruments expose the Company to credit loss in the event of nonperformance by the counterparties to the agreements. However, the Company does not expect any of the counterparties to fail to meet their obligations. The credit exposure related to these financial instruments is represented by the fair value of contracts with a positive fair value at the reporting date. To manage credit risk, the Company selects and periodically reviews counterparties based on credit ratings, limits its exposure to a single counterparty, and monitors the market position of the program and its relative market position with each counterparty. At December 31, 2006, the Company had agreements with eight counterparties containing early termination rights and/or bilateral collateral provisions whereby security is required if market risk exposure exceeds a specified threshold amount or credit ratings fall below certain levels. At December 31, 2006, the Company held \$540 million in fuel hedge related cash collateral deposits under these bilateral collateral provisions. These collateral deposits serve to decrease, but not totally eliminate, the credit risk associated with the Company's hedging program. The cash deposits, which can have a significant impact on the Company's cash balance and cash flows as of and for a particular operating period, are included in Accrued liabilities on the Consolidated Balance Sheet and are included as Operating cash flows in the Consolidated Statement of Cash Flows.

The carrying amounts and estimated fair values of the Company's long-term debt and fuel contracts at December 31, 2006 were as follows:

|                                   | <b>Carrying<br/>Value</b> | <b>Estimated Fair<br/>Value</b> |
|-----------------------------------|---------------------------|---------------------------------|
|                                   |                           | (In millions)                   |
| 77/8% Notes due 2007              | \$ 100                    | \$ 102                          |
| French Credit Agreements due 2012 | 37                        | 37                              |
| 61/2% Notes due 2012              | 369                       | 385                             |
| 51/4% Notes due 2014              | 336                       | 325                             |
| 53/4% Notes due 2016              | 300                       | 293                             |
| 51/8% Notes due 2017              | 300                       | 279                             |
| French Credit Agreements due 2017 | 100                       | 100                             |
| 73/8% Debentures due 2027         | 100                       | 110                             |
| Fuel contracts                    | 999                       | 999                             |

The estimated fair values of the Company's publicly held long-term debt were based on quoted market prices. The carrying values of all other financial instruments approximate their fair value.

**11. Comprehensive Income**

Comprehensive income includes changes in the fair value of certain financial derivative instruments, which qualify for hedge accounting, and unrealized gains and losses on certain investments. Comprehensive income totaled \$189 million, \$959 million, and \$510 million for 2006, 2005, and 2004, respectively. The differences between Net income and Comprehensive income for these years are as follows:

|   | <b>2006</b>          | <b>2005</b>   | <b>2004</b>   |
|---|----------------------|---------------|---------------|
|   | <b>(In millions)</b> |               |               |
| <b>Net income</b>   | <b>\$ 499</b>        | <b>\$ 484</b> | <b>\$ 215</b> |
| Unrealized gain (loss) on derivative instruments, net of deferred taxes of (\$201), \$300 and \$185 | <b>( 306)</b>        | 474           | 293           |
| Other, net of deferred taxes of (\$2), \$1 and \$1  | <b>(4)</b>           | 1             | 2             |
| Total other comprehensive income (loss)   | <b>( 310)</b>        | 475           | 295           |
| <b>Comprehensive income</b>   | <b>\$ 189</b>        | <b>\$ 959</b> | <b>\$ 510</b> |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

A rollforward of the amounts included in Accumulated other comprehensive income (loss), net of taxes for 2006, 2005, and 2004, is shown below:

|                                     | <b>Fuel<br/>Hedge<br/>Derivatives</b> | <b>Other<br/><br/>(In millions)</b> | <b>Accumulated<br/>other<br/>Comprehensive<br/>Income (Loss)</b> |
|-------------------------------------|---------------------------------------|-------------------------------------|--|
| Balance at December 31, 2004        | \$ 416                                | \$ 1                                | \$ 417   |
| 2005 changes in fair value          | 999                                   | 1                                   | 1,000  |
| Reclassification to earnings        | (525)                                 |                                     | (525)  |
| Balance at December 31, 2005        | 890                                   | 2                                   | 892  |
| <b>2006 changes in fair value</b>   | <b>52</b>                             | <b>(4)</b>                          | <b>48</b>  |
| <b>Reclassification to earnings</b> | <b>(358)</b>                          |                                     | <b>(358)</b>   |
| <b>Balance at December 31, 2006</b> | <b>\$ 584</b>                         | <b>\$ (2)</b>                       | <b>\$ 582</b>  |

**12. Common Stock**

The Company has one class of common stock. Holders of shares of common stock are entitled to receive dividends when and if declared by the Board of Directors and are entitled to one vote per share on all matters submitted to a vote of the shareholders. At December 31, 2006, the Company had 208 million shares of common stock reserved for issuance pursuant to Employee stock benefit plans (of which 39 million shares have not been granted.)

In January 2004, the Company's Board of Directors authorized the repurchase of up to \$300 million of the Company's common stock, utilizing proceeds from the exercise of Employee stock options. Repurchases were made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. During first quarter 2005, the Company completed this program. In total, the Company repurchased approximately 20.9 million of its common shares during the course of the program.

In 2006, the Company's Board of Directors authorized three separate programs for the repurchase of up to a total of \$1.0 billion of the Company's Common Stock: \$300 million authorized in January 2006, \$300 million authorized in May 2006, and \$400 million authorized in November 2006. Repurchases have been made in accordance with applicable securities laws in the open market or in private transactions from time to time, depending on market conditions. Through December 31, 2006, these programs resulted in the 2006 repurchase of a total of 49 million shares for \$800 million.

**13. Stock Plans***Share-Based Compensation*

The Company has share-based compensation plans covering the majority of its Employee groups, including plans adopted via collective bargaining, a plan covering the Company's Board of Directors, and plans related to employment contracts with one Executive Officer of the Company. Effective January 1, 2006, the Company adopted the fair value recognition provisions of SFAS No. 123R, Share-Based Payment using the modified retrospective transition method. Among other items, SFAS 123R eliminates the use of APB 25 and the intrinsic value method of accounting, and requires companies to recognize the cost of Employee services received in exchange for awards of equity instruments, based on the grant date fair value of those awards, in the financial statements.

Under the modified retrospective method, compensation cost is recognized in the financial statements beginning with the effective date, based on the requirements of SFAS 123R for all share-based payments granted after that date, and based on the requirements of SFAS 123 for all unvested awards granted prior to the effective date of SFAS 123R. In addition, results for prior periods were retrospectively adjusted in first quarter 2006 utilizing the pro forma disclosures in those prior financial statements, except as noted. The Consolidated Statement of Income for the years ended December 31, 2006, 2005, and 2004 reflects share-based compensation cost of \$80 million, \$80 million, and \$135 million, respectively. The total tax benefit recognized from share-based compensation arrangements for the years ended December 31, 2006, 2005, and 2004, was \$27 million, \$25 million, and \$46 million, respectively. The Company's earnings

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

before income taxes (net of profitsharing), and net earnings for the year ended December 31, 2006, were reduced by \$68 million and \$41 million, respectively, compared to the previous accounting method under APB 25. Net income per share, basic and diluted were reduced by \$.05 and \$.05 for the year ended December 31, 2006, compared to the previous accounting method under APB 25. As a result of the SFAS 123R retroactive application, for the year ended December 31, 2005, net income was reduced by \$55 million, net income per share, basic was reduced by \$.08, and net income per share, diluted was reduced by \$.06. For the year ended December 31, 2004, net income was reduced by \$89 million, net income per share, basic was reduced by \$.12, and net income per share, diluted was reduced by \$.10.

Prior to the adoption of SFAS 123R, the Company was required to record benefits associated with the tax deductions in excess of recognized compensation cost as an operating cash flow. However, SFAS 123R requires that such benefits be recorded as a financing cash inflow and corresponding operating cash outflow. In the accompanying Consolidated Statement of Cash Flows for years ended December 31, 2005, and 2004, the respective \$47 million, and \$23 million tax benefits classified as financing cash flows (and corresponding operating cash outflows) have been conformed to the current year presentation.

***Stock Plans***

The Company has stock plans covering Employees subject to collective bargaining agreements (collective bargaining plans) and stock plans covering Employees not subject to collective bargaining agreements (other Employee plans). None of the collective bargaining plans were required to be approved by shareholders. Options granted to Employees under collective bargaining plans are non-qualified, granted at or above the fair market value of the Company's Common Stock on the date of grant, and generally have terms ranging from six to twelve years. Neither Executive Officers nor members of the Company's Board of Directors are eligible to participate in any of these collective bargaining plans. Options granted to Employees through other Employee plans are both qualified as incentive stock options under the Internal Revenue Code of 1986 and non-qualified stock options, granted at the fair market value of the Company's Common Stock on the date of grant, and have ten-year terms. All of the options included under the heading of Other Employee Plans have been approved by shareholders, except the plan covering non-management, non-contract Employees, which had options outstanding to purchase 5.5 million shares of the Company's Common Stock as of December 31, 2006. Although the Company does not have a formal policy per se, upon option exercise, the Company will typically issue Treasury stock, to the extent such shares are available.

Vesting terms for the collective bargaining plans differ based on the grant made, and have ranged in length from immediate vesting to vesting periods in accordance with the period covered by the respective collective bargaining agreement. For Other Employee Plans, options vest and become fully exercisable over three, five, or ten years of continued employment, depending upon the grant type. For grants in any of the Company's plans that are subject to graded vesting over a service period, Southwest recognizes expense on a straight-line basis over the requisite service period for the entire award. None of the Company's grants include performance-based or market-based vesting conditions, as defined.

The fair value of each option grant is estimated on the date of grant using a modified Black-Scholes option pricing model. The following weighted-average assumptions were used for grants made under the fixed option plans for the current and prior year:

| 2006 | 2005 | 2004 |
|------|------|------|
|------|------|------|

|                                     |              |       |       |
|-------------------------------------|--------------|-------|-------|
| Wtd-average risk-free interest rate | <b>4.6%</b>  | 4.1%  | 3.1%  |
| Expected life of option (years)     | <b>5.0</b>   | 4.7   | 4.0   |
| Expected stock volatility           | <b>26.0%</b> | 26.2% | 34.0% |
| Expected dividend yield             | <b>0.07%</b> | 0.09% | 0.11% |

The Black-Scholes option valuation model was developed for use in estimating the fair value of short-term traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of somewhat subjective assumptions including expected stock price volatility. For 2006 and 2005, the Company has relied on observations of both historical volatility trends as well as implied future volatility observations as determined by independent third parties. For both 2006 and 2005 stock option grants, the

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Company utilized expected volatility based on the expected life of the option, but within a range of 25% to 27%. Prior to 2005, the Company relied exclusively on historical volatility as an input for determining the estimated fair value of stock options. In determining the expected life of the option grants, the Company has observed the actual terms of prior grants with similar characteristics, the actual vesting schedule of the grant, and assessed the expected risk tolerance of different optionee groups. The risk-free interest rates used, which were actual U.S. Treasury zero-coupon rates for bonds matching the expected term of the option as of the option grant date, ranged from 4.26% to 5.24% for the year ended December 31, 2006, from 3.37% to 4.47% for 2005, and from 2.16% to 4.62% for 2004.

The fair value of options granted under the fixed option plans during the year ended December 31, 2006, ranged from \$2.48 to \$6.99, with a weighted-average fair value of \$5.47. The fair value of options granted under the fixed option plans during 2005 ranged from \$2.90 to \$6.79, with a weighted-average fair value of \$4.49. The fair value of options granted under the fixed option plans during 2004 ranged from \$3.45 to \$7.83, with a weighted-average fair value of \$4.49.

Aggregated information regarding the Company's fixed stock option plans is summarized below:

|  |                | <b>Collective Bargaining Plans</b> |                     |    |                         |
|--|----------------|------------------------------------|---------------------|----|-------------------------|
|  |                | <b>Wtd.</b>                        | <b>Wtd. Average</b> |    |                         |
|  | <b>Options</b> | <b>Average</b>                     | <b>Remaining</b>    |    | <b>Aggregate</b>        |
|  | <b>(000)</b>   | <b>Exercise</b>                    | <b>Contractual</b>  |    | <b>Intrinsic</b>        |
|  |                | <b>Price</b>                       | <b>Term</b>         |    | <b>Value (Millions)</b> |
| Outstanding December 31, 2003                      | 120,058        | \$ 10.47                           |                     |    |                         |
| Granted  | 14,131         | 14.41                              |                     |    |                         |
| Exercised  | (7,222)        | 6.59                               |                     |    |                         |
| Surrendered  | (6,264)        | 13.62                              |                     |    |                         |
| Outstanding December 31, 2004                      | 120,703        | \$ 10.98                           |                     |    |                         |
| Granted  | 1,697          | 14.91                              |                     |    |                         |
| Exercised  | (14,739)       | 6.13                               |                     |    |                         |
| Surrendered  | (2,417)        | 13.89                              |                     |    |                         |
| Outstanding December 31, 2005                      | 105,244        | \$ 11.65                           |                     |    |                         |
| Granted  | 1,025          | 16.64                              |                     |    |                         |
| Exercised  | (24,632)       | 7.91                               |                     |    |                         |
| Surrendered  | (1,427)        | 14.25                              |                     |    |                         |
| Outstanding December 31, 2006                      | 80,210         | \$ 12.83                           | 4.1                 | \$ | 224                     |
| Vested or expected to vest at<br>December 31, 2006 | 78,270         | \$ 12.79                           | 4.1                 | \$ | 222                     |
| Exercisable at December 31, 2006                   | 70,688         | \$ 12.55                           | 3.9                 | \$ | 215                     |





## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|                                  |         | Other Employee Plans |              |    |                  |
|----------------------------------|---------|----------------------|--------------|----|------------------|
|                                  |         | Wtd.                 | Wtd. Average |    | Aggregate        |
|                                  | Options | Average              | Remaining    |    | Intrinsic        |
|                                  | (000)   | Exercise             | Contractual  |    | Value (Millions) |
|                                  |         | Price                | Term         |    |                  |
| Outstanding December 31, 2003    | 34,552  | \$ 12.21             |              |    |                  |
| Granted                          | 4,255   | 15.05                |              |    |                  |
| Exercised                        | (3,133) | 6.79                 |              |    |                  |
| Surrendered                      | (1,453) | 14.54                |              |    |                  |
| Outstanding December 31, 2004    | 34,221  | \$ 12.94             |              |    |                  |
| Granted                          | 6,662   | 15.60                |              |    |                  |
| Exercised                        | (3,800) | 7.09                 |              |    |                  |
| Surrendered                      | (1,263) | 15.60                |              |    |                  |
| Outstanding December 31, 2005    | 35,820  | \$ 13.96             |              |    |                  |
| Granted                          | 2,831   | 17.52                |              |    |                  |
| Exercised                        | (5,015) | 9.57                 |              |    |                  |
| Surrendered                      | (1,442) | 15.93                |              |    |                  |
| Outstanding December 31, 2006    | 32,194  | \$ 14.87             | 5.5          | \$ | 46               |
| Vested or expected to vest at    |         |                      |              |    |                  |
| December 31, 2006                | 31,356  | \$ 14.85             | 5.5          | \$ | 45               |
| Exercisable at December 31, 2006 | 20,094  | \$ 14.65             | 4.9          | \$ | 32               |

The total aggregate intrinsic value of options exercised during the years ended December 31, 2006, 2005, and 2004, was \$262 million, \$179 million, and \$106 million, respectively. The total fair value of shares vesting during the years ended December 31, 2006, 2005, and 2004, was \$112 million, \$96 million, and \$114 million, respectively. As of December 31, 2006, there was \$74 million of total unrecognized compensation cost related to share-based compensation arrangements, which is expected to be recognized over a weighted-average period of 1.9 years. The total recognition period for the remaining unrecognized compensation cost is approximately ten years; however, the majority of this cost will be recognized over the next two years, in accordance with vesting provisions.

### *Employee Stock Purchase Plan*

Under the amended 1991 Employee Stock Purchase Plan (ESPP), which has been approved by shareholders, the Company is authorized to issue up to a remaining balance of 7.8 million shares of Common Stock to Employees of the Company. These shares may be issued at a price equal to 90 percent of the market value at the end of each monthly purchase period. Common Stock purchases are paid for through periodic payroll deductions. For the years ended December 31, 2006, 2005, and 2004, participants under the plan purchased 1.2 million shares, 1.5 million shares, and 1.5 million shares at average prices of \$14.86, \$13.19, and \$13.47, respectively. The weighted-average fair value of each purchase right under the ESPP granted for the years ended December 31, 2006, 2005, and 2004, which is equal to the ten percent discount from the market value of the Common Stock at the end of each monthly purchase period,

was \$1.65, \$1.47, and \$1.50, respectively.

***Non-Employee Director Grants and Incentive Plan***

During the term of the 1996 Non-Qualified Stock Option Plan (1996 Plan), upon initial election to the Board, non-Employee Directors received a one-time option grant to purchase 10,000 shares of Southwest Common Stock at the fair market value of such stock on the date of the grant. The Company's 1996 Plan, which is administered by the Compensation Committee of the Board of Directors, has expired and no additional options may be granted from the plan. Outstanding stock options to the Board under the 1996 Plan become exercisable over a period of five years from the grant date and have a term of 10 years. In 2001, the Board adopted the Southwest Airlines Co. Outside Director Incentive Plan. The purpose of the plan is to align more closely the interests of the non-Employee Directors with those of the Company's Shareholders and to provide the non-Employee Directors with retirement income. To accomplish this

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

purpose, the plan compensates each non-Employee Director based on the performance of the Company's Common Stock and defers the receipt of such compensation until after the non-Employee Director ceases to be a Director of the Company. Pursuant to the plan, on the date of the 2002 Annual Meeting of Shareholders, the Company granted 750 non-transferable Performance Shares to each non-Employee Director who had served as a Director since at least May 2001. Thereafter, on the date of each Annual Meeting of Shareholders, the Company will grant 750 Performance Shares to each non-Employee Director who has served since the previous Annual Meeting. A Performance Share is a unit of value equal to the Fair Market Value of a share of Southwest Common Stock, based on the average closing sale price of the Common Stock as reported on the New York Stock Exchange during a specified period. On the 30th calendar day following the date a non-Employee Director ceases to serve as a Director of the Company for any reason, Southwest will pay to such non-Employee Director an amount equal to the Fair Market Value of the Common Stock during the 30 days preceding such last date of service multiplied by the number of Performance Shares then held by such Director. The plan contains provisions contemplating adjustments on changes in capitalization of the Company. The Company accounts for grants made under this plan as liability awards, as defined, and since the awards are not stock options, they are not reflected in the above tables. The fair value of the awards as of December 31, 2006, which is not material to the Company, is included in Accrued liabilities in the accompanying Condensed Consolidated Balance Sheet.

***Taxes***

A portion of the Company's granted options qualify as incentive stock options (ISO) for income tax purposes. As such, a tax benefit is not recorded at the time the compensation cost related to the options is recorded for book purposes due to the fact that an ISO does not ordinarily result in a tax benefit unless there is a disqualifying disposition. Stock option grants of non-qualified options result in the creation of a deferred tax asset, which is a temporary difference, until the time that the option is exercised. Due to the treatment of incentive stock options for tax purposes, the Company's effective tax rate from year to year is subject to variability.

**14. Employee Retirement Plans**

***Defined Contribution Plans***

The Company has defined contribution plans covering substantially all Southwest Employees. The Southwest Airlines Co. Profitsharing Plan is a money purchase defined contribution plan and Employee stock purchase plan. The Company also sponsors Employee savings plans under section 401(k) of the Internal Revenue Code, which include Company matching contributions. The 401(k) plans cover substantially all Employees. Contributions under all defined contribution plans are primarily based on Employee compensation and performance of the Company.

Company contributions to all retirement plans expensed in 2006, 2005, and 2004 were \$301 million, \$264 million, and \$200 million, respectively.

***Postretirement Benefit Plans***

The Company provides postretirement benefits to qualified retirees in the form of medical and dental coverage. Employees must meet minimum levels of service and age requirements as set forth by the Company, or as specified in collective bargaining agreements with specific workgroups. Employees meeting these requirements, as defined, may use accrued sick time to pay for medical and dental premiums from the age of retirement until age 65.

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The following table shows the change in the Company's accumulated postretirement benefit obligation (APBO) for the years ended December 31, 2006 and 2005:

|                             | <b>2006</b>          | <b>2005</b> |
|-----------------------------|----------------------|-------------|
|                             | <b>(In millions)</b> |             |
| APBO at beginning of period | \$ 94                | \$ 80       |
| Service cost                | 15                   | 12          |
| Interest cost               | 5                    | 4           |
| Benefits paid               | (5)                  | (2)         |
| Actuarial (gain) loss       | 2                    |             |
| Plan amendments             |                      |             |
| APBO at end of period       | \$ 111               | \$ 94       |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The assumed healthcare cost trend rates have a significant effect on the amounts reported for the Company's plan. A one-percent change in all healthcare cost trend rates used in measuring the APBO at December 31, 2006, would have the following effects:

|  | <b>1% Increase</b>   | <b>1% Decrease</b> |        |
|--|----------------------|--------------------|--------|
|  | <b>(In millions)</b> |                    |        |
| Increase (decrease) in total service and interest cost | \$                   | 2                  | \$ (2) |
| Increase (decrease) in the APBO                        | \$                   | 8                  | \$ (8) |

The Company's plans are unfunded, and benefits are paid as they become due. For 2006, both benefits paid and Company contributions to the plans were each \$5 million. For 2005, both benefits paid and Company contributions to the plans were each \$2 million. Estimated future benefit payments expected to be paid for each of the next five years are \$6 million in 2007, \$8 million in 2008, \$10 million in 2009, \$12 million in 2010, \$15 million in 2011, and \$106 million for the next five years thereafter.

On December 31, 2006, the Company adopted the recognition and disclosure provisions of SFAS 158. SFAS 158 required the Company to recognize the funded status (i.e., the difference between the fair value of plan assets and the projected benefit obligations) of its benefit plans in the December 31, 2006 Consolidated Balance Sheet, with a corresponding adjustment to accumulated other comprehensive income, net of tax. The net adjustment to accumulated other comprehensive income at adoption of \$11 million (\$7 million net of tax) represents the net unrecognized actuarial losses and unrecognized prior service costs. The effects of adopting the provisions of SFAS 158 on the Company's Consolidated Balance Sheet at December 31, 2006, are presented in the following table.

The following table shows the calculation of the accrued postretirement benefit cost recognized in Other deferred liabilities on the Company's Consolidated Balance Sheet at December 31, 2006 and 2005:

|   | <b>2006</b>          | <b>2005</b> |
|---|----------------------|-------------|
|   | <b>(In millions)</b> |             |
| Funded status                                 | \$ (111)             | \$ (94)     |
| Unrecognized net actuarial loss               | 7                    | 4           |
| Unrecognized prior service cost               | 4                    | 6           |
| Accumulated other comprehensive income        | (11)                 |             |
| Cost recognized on Consolidated Balance Sheet | \$ (111)             | \$ (84)     |

The Company's periodic postretirement benefit cost for the years ended December 31, 2006, 2005, and 2004, included the following:

| <b>2006</b>          | <b>2005</b> | <b>2004</b> |
|----------------------|-------------|-------------|
| <b>(In millions)</b> |             |             |

|  |       |       |       |
|--|-------|-------|-------|
| Service cost                             | \$ 15 | \$ 12 | \$ 10 |
| Interest cost                            | 5     | 4     | 5     |
| Amortization of prior service cost       | 2     | 2     | 2     |
| Recognized actuarial loss                | (1)   |       | 1     |
| Net periodic postretirement benefit cost | \$ 21 | \$ 18 | \$ 18 |

Unrecognized prior service cost is expensed using a straight-line amortization of the cost over the average future service of Employees expected to receive benefits under the plan. The Company used the following actuarial assumptions to account for its postretirement benefit plans at December 31:

|                                       | 2006  | 2005  | 2004   |
|---------------------------------------|-------|-------|--------|
| Wtd-average discount rate             | 5.25% | 5.25% | 6.25%  |
| Assumed healthcare cost trend rate(1) | 8.50% | 9.00% | 10.00% |

(1) The assumed healthcare cost trend rate is assumed to remain at 8.50% for 2007, then decline gradually to 5% by 2014 and remain level thereafter.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****15. Income Taxes**

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. The components of deferred tax assets and liabilities at December 31, 2006 and 2005, are as follows:

|  | <b>2006</b>          | <b>2005</b> |
|--|----------------------|-------------|
|  | <b>(In millions)</b> |             |
| <b>DEFERRED TAX LIABILITIES:</b>                   |                      |             |
| Accelerated depreciation                           | \$ 2,405             | \$ 2,251    |
| Fuel hedges  | 363                  | 563         |
| Other  | 1                    | 4           |
| Total deferred tax liabilities                     | <b>2,769</b>         | 2,818       |
| <b>DEFERRED TAX ASSETS:</b>                        |                      |             |
| Deferred gains from sale and leaseback of aircraft | 70                   | 76          |
| Capital and operating leases                       | 65                   | 70          |
| Accrued employee benefits                          | 160                  | 132         |
| Stock-based compensation                           | 122                  | 128         |
| State taxes  | 55                   | 57          |
| Net operating loss carry forward                   | 22                   | 164         |
| Other  | 93                   | 21          |
| Total deferred tax assets                          | <b>587</b>           | 648         |
| Net deferred tax liability                         | <b>\$ 2,182</b>      | \$ 2,170    |

The provision for income taxes is composed of the following:

|                  | <b>2006</b>          | <b>2005</b> | <b>2004</b> |
|------------------|----------------------|-------------|-------------|
|                  | <b>(In millions)</b> |             |             |
| <b>CURRENT:</b>  |                      |             |             |
| Federal          | \$ 64                | \$ 43       | \$ (20)     |
| State            | 15                   | 7           |             |
| Total current    | <b>79</b>            | 50          | (20)        |
| <b>DEFERRED:</b> |                      |             |             |
| Federal          | 220                  | 231         | 140         |
| State            | (8)                  | 14          | 4           |
| Total deferred   | <b>212</b>           | 245         | 144         |

\$ 291      \$ 295      \$ 124

For the year 2004, Southwest Airlines Co. had a tax net operating loss of \$616 million for federal income tax purposes. The Company carried a portion of this net operating loss back to prior periods, resulting in a \$35 million refund of federal taxes previously paid. This refund was received during 2005. The Company applied a portion of this 2004 net operating loss to the 2005 and 2006 tax years, resulting in the payment of no regular federal income taxes for these years. The remaining portion of the Company's federal net operating loss that can be carried forward to future years is estimated at \$59 million, and expires in 2024.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The effective tax rate on income before income taxes differed from the federal income tax statutory rate for the following reasons:

|  | <b>2006</b>          | <b>2005</b> | <b>2004</b> |
|--|----------------------|-------------|-------------|
|  | <b>(In millions)</b> |             |             |
| Tax at statutory U.S. tax rates            | <b>\$ 276</b>        | \$ 274      | \$ 123      |
| Nondeductible items                        | <b>10</b>            | 8           | 7           |
| State income taxes, net of federal benefit | <b>4</b>             | 14          | 3           |
| Other, net                                 | <b>1</b>             | (1)         | (9)         |
| <b>Total income tax provision</b>          | <b>\$ 291</b>        | \$ 295      | \$ 124      |

The Internal Revenue Service (IRS) regularly examines the Company's federal income tax returns and, in the course of which, may propose adjustments to the Company's federal income tax liability reported on such returns. It is the Company's practice to vigorously contest those proposed adjustments that it deems lacking of merit. The Company's management does not expect that the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations, or cash flows.

**16. Net Income Per Share**

The following table sets forth the computation of net income per share, basic and diluted:

|  | <b>2006</b>                                    | <b>2005</b> | <b>2004</b> |
|--|--|-------------|-------------|
|  | <b>(In millions, except per share amounts)</b> |             |             |
| Net income   | <b>\$ 499</b>                                  | \$ 484      | \$ 215      |
| Weighted-average shares outstanding, basic                   | <b>795</b>                                     | 789         | 783         |
| Dilutive effect of Employee stock options                    | <b>29</b>                                      | 17          | 21          |
| <b>Adjusted weighted-average shares outstanding, diluted</b> | <b>824</b>                                     | 806         | 804         |
| Net income per share, basic                                  | <b>\$ .63</b>                                  | \$ .61      | \$ .27      |
| Net income per share, diluted                                | <b>\$ .61</b>                                  | \$ .60      | \$ .27      |

The Company has excluded 20 million, 12 million, and 31 million shares from its calculations of net income per share, diluted, in 2006, 2005, and 2004, respectively, as they represent antidilutive stock options for the respective periods presented.

## 17. Contingencies

The Company is subject to various legal proceedings and claims arising in the ordinary course of business, including, but not limited to, examinations by the Internal Revenue Service (IRS). The IRS regularly examines the Company's federal income tax returns and, in the course thereof, proposes adjustments to the Company's federal income tax liability reported on such returns. It is the Company's practice to vigorously contest those proposed adjustments it deems lacking of merit.

The Company's management does not expect that the outcome in any of its currently ongoing legal proceedings or the outcome of any proposed adjustments presented to date by the IRS, individually or collectively, will have a material adverse effect on the Company's financial condition, results of operations or cash flow.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

THE BOARD OF DIRECTORS AND SHAREHOLDERS  
SOUTHWEST AIRLINES CO.

We have audited the accompanying consolidated balance sheets of Southwest Airlines Co. as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2006. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Southwest Airlines Co. at December 31, 2006 and 2005, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2006, in conformity with U.S. generally accepted accounting principles.

As discussed in Note 2 to the consolidated financial statements, in 2006 the Company changed its method of accounting for scheduled airframe inspection and repairs on a retrospective basis, changed its method of accounting for share-based compensation using the modified-retrospective method, and changed its method of accounting for postretirement benefit plans.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Southwest Airlines Co.'s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 30, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, TX  
January 30, 2007

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

THE BOARD OF DIRECTORS AND SHAREHOLDERS  
SOUTHWEST AIRLINES CO.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting, that Southwest Airlines Co. maintained effective internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Southwest Airlines management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Southwest Airlines Co. maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Southwest Airlines Co. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Southwest Airlines Co. as of December 31, 2006 and 2005, and the related consolidated statements of income, stockholder's equity, and cash flows for each of the three years in the period ended December 31, 2006 of Southwest Airlines Co. and our report dated January 30, 2007 expressed an unqualified opinion thereon.

/s/ Ernst & Young LLP

Dallas, TX  
January 30, 2007

**QUARTERLY FINANCIAL DATA**  
**(Unaudited)**

|                               | <b>Three Months Ended</b>                     |                |                 |                |
|-------------------------------|---|----------------|-----------------|----------------|
|                               | <b>March 31</b>                               | <b>June 30</b> | <b>Sept. 30</b> | <b>Dec. 31</b> |
|                               | <b>(In millions except per share amounts)</b> |                |                 |                |
| <b>2006</b>                   |   |                |                 |                |
| Operating revenues            | \$ 2,019                                      | \$ 2,449       | \$ 2,342        | \$ 2,276       |
| Operating income              | 98  | 402            | 261             | 174            |
| Income before income taxes    | 96  | 515            | 78              | 101            |
| Net income                    | 61  | 333            | 48              | 57             |
| Net income per share, basic   | .08   | .42            | .06             | .07            |
| Net income per share, diluted | .07   | .40            | .06             | .07            |
|                               | <b>March 31</b>                               | <b>June 30</b> | <b>Sept. 30</b> | <b>Dec. 31</b> |
| <b>2005</b>                   |   |                |                 |                |
| Operating revenues            | \$ 1,663                                      | \$ 1,944       | \$ 1,989        | \$ 1,987       |
| Operating income              | 81  | 256            | 248             | 140            |
| Income before income taxes    | 89  | 235            | 343             | 113            |
| Net income                    | 59  | 144            | 210             | 70             |
| Net income per share, basic   | .08   | .18            | .27             | .09            |
| Net income per share, diluted | .07   | .18            | .26             | .09            |

**Item 15. Exhibits and Financial Statement Schedules**

(a) 1. *Financial Statements:*

The financial statements included in Item 8 above are filed as part of this annual report.

2. *Financial Statement Schedules:*

There are no financial statement schedules filed as part of this annual report, since the required information is included in the consolidated financial statements, including the notes thereto, or the circumstances requiring inclusion of such schedules are not present.

3. *Exhibits:*

- 3.1 Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 4.1 to Southwest's Registration Statement on Form S-3 (File No. 33-52155)); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 3.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 1996 (File No. 1-7259)); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 3.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 1998 (File No. 1-7259)); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 4.2 to Southwest's Registration Statement on Form S-8 (File No. 333-82735)); Amendment to Restated Articles of Incorporation of Southwest (incorporated by reference to Exhibit 3.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2001 (File No. 1-7259)).
- 3.2 Bylaws of Southwest, as amended through January 2007 (incorporated by reference to Exhibit 3.2 to Southwest's Current Report on Form 8-K dated January 18, 2007).
- 4.1 \$600,000,000 Competitive Advance and Revolving Credit Facility Agreement dated as of April 20, 2004 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); First Amendment, dated as of August 9, 2005, to Competitive Advance Revolving Credit Agreement (incorporated by reference to Exhibit 10.1 to Southwest's Current Report on Form 8-K dated August 12, 2005 (File No. 1-7259)).
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- 4.4 Indenture dated as of September 17, 2004 between Southwest Airlines Co. and Wells Fargo Bank, N.A., Trustee (incorporated by reference to Exhibit 4.1 to Southwest's Registration Statement on Form S-3 dated October 30, 2002 (File No. 1-7259)).
- 4.5 Indenture dated as of June 20, 1991, between Southwest Airlines Co. and Bank of New York, successor to NationsBank of Texas, N.A. (formerly NCNB Texas National Bank), Trustee (incorporated by reference to Exhibit 4.1 to Southwest's Current Report on Form 8-K dated June 24, 1991 (File No. 1-7259)).
- 4.6 Indenture dated as of February 25, 1997, between the Company and U.S. Trust Company of Texas, N.A. (incorporated by reference to Exhibit 4.2 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)).

Southwest is not filing any other instruments evidencing any indebtedness because the total amount of securities authorized under any single such instrument does not exceed 10 percent of its total consolidated assets. Copies of such instruments will be furnished to the Securities and Exchange Commission upon request.

- 10.1 Purchase Agreement No. 1810, dated January 19, 1994, between The Boeing Company and Southwest (incorporated by reference to Exhibit 10.4 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1993 (File No. 1-7259)); Supplemental Agreement No. 1. (incorporated by reference to



Exhibit 10.3 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1996 (File No. 1-7259)); Supplemental Agreements Nos. 2, 3 and 4 (incorporated by reference to Exhibit 10.2 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 1-7259)); Supplemental Agreements Nos. 5, 6, and 7; (incorporated by reference to Exhibit 10.1 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1998 (File No. 1-7259)); Supplemental Agreements Nos. 8, 9, and 10 (incorporated by reference to Exhibit 10.1 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1999 (File No. 1-7259)); Supplemental Agreements Nos. 11, 12, 13 and 14 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2000 (File No. 1-7259)); Supplemental Agreements Nos. 15, 16, 17, 18 and 19 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2001 (File No. 1-7259)); Supplemental Agreements Nos. 20, 21, 22, 23 and 24 (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2002 (File No. 1-7259)); Supplemental Agreements Nos. 25, 26, 27, 28 and 29 to Purchase Agreement No. 1810, dated January 19, 1994, between The Boeing Company and Southwest (incorporated by reference to Exhibit 10.8 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Supplemental Agreements Nos. 30, 31, 32, and 33 to Purchase Agreement No. 1810, dated January 19, 1993 between The Boeing Company and Southwest; (incorporated by reference to Exhibit 10.1 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Supplemental Agreements Nos. 34, 35, 36, 37, and 38 (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); Supplemental Agreements Nos. 39 and 40 (incorporated by reference to Exhibit 10.6 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)); Supplemental Agreement No. 41; Supplemental Agreement Nos. 42, 43 and 44 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (File No. 1-7259)); Supplemental Agreement No. 45 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005 (File No. 1-7259)); Supplemental Agreement Nos. 46 and 47 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 (File No. 1-7259)); Supplemental Agreement No. 48 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (File No. 1-7259)); Supplemental Agreements No. 49 and 50 (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 (File No. 1-7259)); Supplemental Agreement No. 51 (filed on February 1, 2007, as part of the original filing of this Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 1-7259)).

Pursuant to 17 CFR 240.24b-2, confidential information has been omitted and has been filed separately with the Securities and Exchange Commission pursuant to a Confidential Treatment Application filed with the Commission.

The following exhibits filed under paragraph 10 of Item 601 are the Company's compensation plans and arrangements.

- 10.2 Form of Executive Employment Agreement between Southwest and certain key employees pursuant to Executive Service Recognition Plan (incorporated by reference to Exhibit 28 to Southwest Quarterly Report on Form 10-Q for the quarter ended June 30, 1987 (File No. 1-7259)).
- 10.3 2001 stock option agreements between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001 (File No. 1-7259)).

- 10.4 1991 Incentive Stock Option Plan (incorporated by reference to Exhibit 10.6 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.5 1991 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.7 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.6 1991 Employee Stock Purchase Plan as amended March 16, 2006 (incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 (File No. 333-139362)).

- 10.7 Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2000 (File No. 1-729)); Amendment No. 1 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.11 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Amendment No. 5 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); Amendment No. 6 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 1-7259)); Amendment No. 7 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 1-7259)); Amendment No. 8 to Southwest Airlines Co. Profit Sharing Plan (filed on February 1, 2007, as part of the original filing of this Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 1-7259)).
- 10.8 Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 1 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Amendment No. 5 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 1-7259)); Amendment No. 6 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 1-7259)); Amendment No. 7 to Southwest Airlines Co. 401(k) Plan (filed on February 1, 2007, as part of the original filing of this Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 1-7259)).
- 10.9 Southwest Airlines Co. 1995 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.14 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1994 (File No. 1-7259)).
- 10.10 1996 Incentive Stock Option Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.11 1996 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.13 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.12 Employment Contract dated as of July 15, 2004, between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q the quarter ended September 30,

2004 (File No. 1-7259)).

- 10.13 Employment Contract dated as of July 15, 2004, between Southwest and Gary C. Kelly (incorporated by reference to Exhibit 10.4 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
- 10.14 Employment Contract dated as of July 15, 2004, between Southwest and Colleen C. Barrett (incorporated by reference to Exhibit 10.5 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
- 10.15 Severance Contract between Jim Wimberly and Southwest Airlines Co., dated as of April 20, 2006 (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (File No. 1-7259)).
- 10.16 Southwest Airlines Co. Outside Director Incentive Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 (File No. 1-7259)).
- 10.17 1998 SAEA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.17 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).

- 10.18 1999 SWAPIA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.18 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.19 LUV 2000 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-53610)).
- 10.20 2000 Aircraft Appearance Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-52388)); Amendment No. 1 to 2000 Aircraft Appearance Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.4 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
- 10.21 2000 Stock Clerks Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-52390)); Amendment No. 1 to 2000 Stock Clerks Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.5 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
- 10.22 2000 Flight Simulator Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-53616)); Amendment No. 1 to 2000 Flight Simulator Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.6 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
- 10.23 2002 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-98761)).
- 10.24 2002 Bonus SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-98761)).
- 10.25 2002 SWAPIA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.2 to Registration Statement on Form S-8 (File No. 333-100862)).
- 10.26 2002 Mechanics Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.2 to Registration Statement on Form S-8 (File No. 333-100862)).
- 10.27 2002 Ramp, Operations, Provisioning and Freight Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.27 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.28 2002 Customer Service/Reservations Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.28 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 1 to 2002 Customer Service/Reservations Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.3 to Registration Statement on Form S-8 (File No. 333-104245)).
- 10.29 2003 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
- 14 Code of Ethics (incorporated by reference to Exhibit 14.1 to Southwest's Current Report on Form 8-K dated November 16, 2006 (File No. 1-7259)).

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21 Subsidiaries of Southwest (incorporated by reference to Exhibit 22 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 1-7259)).

23 Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.

31.1 Rule 13a-14(a) Certification of Chief Executive Officer.

31.2 Rule 13a-14(a) Certification of Chief Financial Officer.

32 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer.

A copy of each exhibit may be obtained at a price of 15 cents per page, \$10.00 minimum order, by writing to: Investor Relations, Southwest Airlines Co., P.O. Box 36611, Dallas, Texas 75235-1611.

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Southwest Airlines Co.

April 23, 2007

By: /s/ LAURA WRIGHT  
Laura Wright  
*Senior Vice President Finance,  
Chief Financial Officer*

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## INDEX TO THE EXHIBITS

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- 10.2 Form of Executive Employment Agreement between Southwest and certain key employees pursuant to Executive Service Recognition Plan (incorporated by reference to Exhibit 28 to Southwest Quarterly Report on Form 10-Q for the quarter ended June 30, 1987 (File No. 1-7259)).
- 10.3 2001 stock option agreements between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2001 (File No. 1-7259)).
- 10.4 1991 Incentive Stock Option Plan (incorporated by reference to Exhibit 10.6 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.5 1991 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.7 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.6 1991 Employee Stock Purchase Plan as amended March 16, 2006 (incorporated by reference to Exhibit 99.1 to Registration Statement on Form S-8 (File No. 333-139362)).
- 10.7 Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2000 (File No. 1-729)); Amendment No. 1 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.11 to Southwest's Annual

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Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Amendment No. 5 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 (File No. 1-7259)); Amendment No. 6 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 1-7259)); Amendment No. 7 to Southwest Airlines Co. Profit Sharing Plan (incorporated by reference to Exhibit 10.8 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 1-7259)); Amendment No. 8 to Southwest Airlines Co. Profit Sharing Plan (filed on February 1, 2007, as part of the original filing of

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this Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 1-7259)).

- 10.8 Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2001 (File No. 1-7259)); Amendment No. 1 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 2 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.10 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 3 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)); Amendment No. 4 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2003 (File No. 1-7259)); Amendment No. 5 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2004 (File No. 1-7259)); Amendment No. 6 to Southwest Airlines Co. 401(k) Plan (incorporated by reference to Exhibit 10.9 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2005 (File No. 1-7259)); Amendment No. 7 to Southwest Airlines Co. 401(k) Plan (filed on February 1, 2007, as part of the original filing of this Annual Report on Form 10-K for the year ended December 31, 2006 (File No. 1-7259)).
- 10.9 Southwest Airlines Co. 1995 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.14 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1994 (File No. 1-7259)).
- 10.10 1996 Incentive Stock Option Plan (incorporated by reference to Exhibit 10.12 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.11 1996 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.13 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.12 Employment Contract dated as of July 15, 2004, between Southwest and Herbert D. Kelleher (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q the quarter ended September 30, 2004 (File No. 1-7259)).
- 10.13 Employment Contract dated as of July 15, 2004, between Southwest and Gary C. Kelly (incorporated by reference to Exhibit 10.4 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
- 10.14 Employment Contract dated as of July 15, 2004, between Southwest and Colleen C. Barrett (incorporated by reference to Exhibit 10.5 to Southwest's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 (File No. 1-7259)).
- 10.15 Severance Contract between Jim Wimberly and Southwest Airlines Co., dated as of April 20, 2006 (incorporated by reference to Exhibit 10.2 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2006 (File No. 1-7259)).
- 10.16 Southwest Airlines Co. Outside Director Incentive Plan (incorporated by reference to Exhibit 10.1 to Southwest's Quarterly Report on Form 10-Q for the quarter ended March 31, 2002 (File No. 1-7259)).

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- 10.17 1998 SAEA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.17 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  - 10.18 1999 SWAPIA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.18 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
  - 10.19 LUV 2000 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-53610)).
  - 10.20 2000 Aircraft Appearance Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-52388)); Amendment No. 1 to 2000 Aircraft Appearance Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.4 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
  - 10.21 2000 Stock Clerks Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-52390)); Amendment No. 1 to 2000 Stock Clerks Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.5 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
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- 10.22 2000 Flight Simulator Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-53616)); Amendment No. 1 to 2000 Flight Simulator Technicians Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.6 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
- 10.23 2002 SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-98761)).
- 10.24 2002 Bonus SWAPA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.1 to Registration Statement on Form S-8 (File No. 333-98761)).
- 10.25 2002 SWAPIA Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.2 to Registration Statement on Form S-8 (File No. 333-100862)).
- 10.26 2002 Mechanics Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.2 to Registration Statement on Form S-8 (File No. 333-100862)).
- 10.27 2002 Ramp, Operations, Provisioning and Freight Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.27 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)).
- 10.28 2002 Customer Service/Reservations Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.28 to Southwest's Annual Report on Form 10-K for the year ended December 31, 2002 (File No. 1-7259)); Amendment No. 1 to 2002 Customer Service/Reservations Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 4.3 to Registration Statement on Form S-8 (File No. 333-104245)).
- 10.29 2003 Non-Qualified Stock Option Plan (incorporated by reference to Exhibit 10.3 to Southwest's Quarterly Report on Form 10-Q for the quarter ended June 30, 2003 (File No. 1-7259)).
- 14 Code of Ethics (incorporated by reference to Exhibit 14.1 to Southwest's Current Report on Form 8-K dated November 16, 2006 (File No. 1-7259)).
- 21 Subsidiaries of Southwest (incorporated by reference to Exhibit 22 to Southwest's Annual Report on Form 10-K for the year ended December 31, 1997 (File No. 1-7259)).
- 23 Consent of Ernst & Young LLP, Independent Registered Public Accounting Firm.
- 31.1 Rule 13a-14(a) Certification of Chief Executive Officer.
- 31.2 Rule 13a-14(a) Certification of Chief Financial Officer.
- 32 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer.